A Carbon Tax Won't Blow Household Budgets

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There's no inflation problem and if there were, a carbon tax wouldn't make it worse. Such talk is distracting from real questions about how to manage rising household energy bills, writes Ian McAuley.

Listening to radio shock jocks and Opposition politicians, one may believe that Australians, already suffering runaway inflation, will be crippled by the additional price impact of a carbon tax.

The reality is that for the last 20 years, annual inflation (measured by changes in consumer prices), has been below 5 per cent, and is currently running at about 3 per cent. At the same time incomes have been rising annually at about 1.2 per cent ahead of inflation. Australians should have little difficulty in managing any small increase in prices resulting from a carbon tax.

Perhaps we like to whinge. As The Economist points out this week in its special feature on Australia, "Many Australians do not seem to appreciate that they live in an unusually successful country".

Or perhaps this campaign on the cost of living is simply a way to get at government. Media attention is on those prices where some — often tenuous — link can be made to government policy while other cost of living pressures are ignored.

As a case in point, the Australia Institute has recently researched retail markups and has found extraordinary figures — 142 per cent on clothes, 85 per cent on electrical goods for example. Even after considering different taxes, Australians are paying far more — often twice as much — than Americans and Europeans for everything from baked beans through to cars. The media has given this research little attention; is it possibly because a large component of retailers' markups is their expenditure on advertising in commercial media?

And there is little, if any, attention to those areas where prices are falling, such as communications.

By contrast there is a great deal of attention on household energy prices, and, as recent national and state election campaigns demonstrate, governments are somehow blamed when we get a nasty shock in our power bills.

Some of that attention is understandable, because for the 20 years up to 2007, electricity prices moved in line with prices generally, but in the last four years they have risen by about 45 per cent in real (inflation-adjusted) terms. There is no respite; this winter will see further rises, and Resources Minister Martin Ferguson has foreshadowed price rises of 30 per cent over the coming three years, regardless of any carbon price effect. Gas, which provides the 30 per cent of household energy not provided by electricity, is showing similar price rises.

Yet, even these price rises do not necessarily indicate hardship. Before these rises, domestic fuels were taking, on average, only 2.0 per cent of household income. That means the recent price rises equate to about 0.9 per cent of income. Hardly what one may call "hardship".

Our awareness of these price rises, perhaps, has to do with the way we pay for electricity and gas, for those bills come in big lumps, generally quarterly. For most items price rises (and falls) pass largely unnoticed as small changes in our everyday purchases: the "boiling frog" syndrome is at work.

There are people, however, in low-income households, who do have difficulty with energy price rises. Before the recent rises, households in the lowest 20 per cent of incomes were paying 6.2 per cent of their income on domestic fuels; those recent rises will now be taking up an extra 3.0 per cent, assuming there's no change in consumption. Many are aged pensioner households, occupied throughout the day. Others with high consumption relative to income include those living in rural regions, where electricity prices are high and where there are summer and winter extreme temperatures.

At first sight, that would seem to leave the Federal Government with a huge equity problem in relation to its plans to price carbon.

A crude solution would be simply to compensate low-income households with some of the proceeds of a carbon tax. Depending on how it would be perceived, that may or may not solve the equity problem — but in itself it may not reduce consumption. In fact, if paid as rebates on utility bills, as some have suggested, it would do nothing to reduce consumption.

In economic theory, we react to rising prices by adjusting our behaviour. In the case of domestic fuels, that may mean investing in insulation, solar water heating, photovoltaic panels, house modifications such as double glazing, and replacing old appliances with more efficient ones.

But it is heroic to expect such a response if we rely on prices alone, because there are five impediments to a rational market adjustment.

First, most such investments, even though they provide good returns, require cash up front, and most low-income households are also low-wealth households. "Compensation" in the form of a higher regular income would not see people accumulating the cash for big investments.

Second, there is little consciousness of electricity and gas prices. Most people know the price of a litre of gasoline, and they know their car's fuel consumption: people know that 12 litres to the hundred kilometers is "high", while six litres is "low". Few have such a feeling for domestic electricity prices — in large part because most utilities have stubbornly refused to modernise their metering technology.

Third, we seldom make rational decisions about minor investments. When compact fluorescent lights came on to the market, for example, the financial case for replacing incandescent bulbs was overwhelming. The investment in a replacement bulb is paid off in a few months; even those who were very hard up for cash would have done well to have borrowed from a payday lender to finance replacement bulbs. Yet, it took a government ban on incandescent bulbs to achieve the change.

Fourth, many people with low incomes live in rented housing, and have no control over matters such as insulation. Landlords have no incentive to invest in energy efficiency, because they are unlikely to recover such outlays in increased rents.

Fifth, such changes are seen as "alternative" or "green", rather than as sensible investments. They belong to Balmain and North Adelaide, not to Campbelltown and Elizabeth. They are not yet part of mainstream thinking. To effect behavioural change, and to fend off criticism that a carbon tax with compensation is simply churning money through a "big new tax", governments must be cleverer than simply paying out "compensation". Whatever is done has to be effective in modifying behaviour, without being heavy-handed.

Some suggestions which warrant exploration are:

- to make payments as lump sums, possibly as low or zero-interest loans for specific purposes. (For example, loans to pensioners for house modifications could be held over until their house is eventually passed to their beneficiaries.) The Government may feel reluctant to become so closely involved after its difficulties with the insulation scheme, but that scheme was necessarily rushed (it was a stimulus measure), was poorly administered, and the Government was pathetic in its failure to respond to hysterical and misleading media beat ups about its problems. With time, the Commonwealth could do far better, particularly if it beings the states on side to administer such measures;

- to require utilities to install user-friendly meters for gas, electricity (and water while they are at it), showing consumption and prices on indoor displays. After all, knowledge of prices and consumption are basic requirements of efficient markets. Such metering is also a precursor to "smart" appliances, which can manage their own energy use;

- to require utilities to re-shape their tariffs, so that the first few kilowatt hours of electricity or the first few megajoules of gas are cheap, with steeply rising prices for subsequent, discretionary units of consumption. Most utilities at present have stepped tariffs, but the steps are very gentle;

- at a minimum to require landlords to provide prospective tenants with realistic estimates of utility charges (e.g. disclosure of what previous tenants have used), and in time to require landlords to upgrade their properties;

- to engage in consumer education, with a particular aim to "normalise" the adoption of domestic energy-saving technologies.

In any event, it is not certain that a carbon price will have a high impact on energy bills. Its effect will be at the wholesale energy supply end, but the wholesale price — the price at the power station or gas plant — is only about 40 per cent of the final consumer price. And, if certainty over carbon policy allows stalled investments to proceed, there should be no more rapid price rises of the kind we have recently experienced.